

[Additional Counsel on Signature Page]

**NORTHSTAR FINANCIAL ADVISORS,
INC., on behalf of itself and all others
similarly situated,**

CLASS ACTION

SCHWAB INVESTMENTS; MARIANN
BYERWALTER, DONALD F.
DORWARD, WILLIAM A. HASLER,
ROBERT G. HOLMES, GERALD B.
SMITH, DONALD R. STEPHENS,
MICHAEL W. WILSEY, CHARLES R.
SCHWAB, RANDALL W. MERK,
JOSEPH H. WENDER and JOHN F.
COGAN, as Trustees of Schwab
Investments; and CHARLES SCHWAB
INVESTMENT MANAGEMENT, INC.,

Defendants.

Date: April 21, 2016
Time: 1:30 p.m.
Courtroom: 8, 4th Floor, San Jose
Judge: Honorable Lucy H. Koh

[08-cv-04119-LHK] DECL. OF STEVEN W. KOHLHAGEN IN SUPPORT OF PLTF'S MOT. FOR CLASS CERT.

1 I, Steven W. Kohlhausen, being duly sworn, hereby declares under the penalties of perjury,
2 pursuant to 28 U.S.C. §1746, that:

3 **I. QUALIFICATIONS, BACKGROUND, AND EXPERIENCE**

4 1. I hold a B.A. in Economics from the College of William & Mary, and an M.Sc. and
5 Ph.D. in Economics from Stanford University. I taught for more than 12 years, first as a lecturer,
6 teaching economics at Stanford University and California State University at Hayward, then as an
7 Associate Professor teaching economics and business courses at the University of California at
8 Berkeley.

9 2. I have obtained a variety of licenses in the investment industry, including Series 7
10 (General Securities Exam), Series 63 (Blue Sky State Exam), Series 24 (General Securities
11 Principal), and Series 3 (Commodities and Futures Exam) licenses.

12 3. I spent two decades in the private sector as a consultant (while on the Berkeley
13 faculty) and later as a managing director at banks and other financial services companies, including:
14 First Union National Bank, predecessor to Wachovia National Bank and the current Wells Fargo;
15 AIG Financial Products; Stamford Capital Group; Bankers Trust Corporation; and Lehman Brothers,
16 Inc. At those institutions, I had responsibility for sales, trading, risk management, and research for
17 investment banking products, including fixed income, equity, and derivative securities. I have also
18 played an active role in the municipal bond business, and commercial and corporate hedging of all
19 financial risks (e.g., interest rate, equity, currency, commodity, etc.), including trading, structuring
20 deals, creating back office support systems, designing marketing materials, and direct marketing to
21 clients.

22 4. Additionally, I have managed a fixed income fund, and have built and managed
23 money management businesses that included equity, fixed income, mutual funds, and municipal
24 bond products. From 2005 to 2010, I served as an Independent Member of the Board of Trustees of
25 the IQ Mutual Funds, a family of Merrill Lynch investment companies, as well as a Chairman of its
26 Nominating and Governance Committee, and as a member of its Audit Committee.

5. In the public sector, I have advised the Federal Reserve Board and the United States Treasury, as well as international organizations, and served as Senior Staff Economist for the Council of Economic Advisers on the White House staff. I currently serve on four private sector boards and committees, including: the Board of Directors of Freddie Mac, chairing its Risk Committee and serving as a member of its Compensation Committee; and the Advisory Board of the Stanford Institute for Economic Policy Research at Stanford University. I have served on various other boards of directors, both as a chairman and as a member of audit, risk, and governance committees. From 2000 to 2001, I sat on the Board of Directors of the Bond Market Association (currently known as the Securities Industry and Financial Markets Association).

6. In my capacity as a financial services industry professional, I gained substantial experience with registration materials and disclosure documents for a wide array of securities products, including mutual funds. In addition to working on drafting and approving these materials and supervising their dissemination to investors, I analyzed and evaluated their comprehensiveness, accuracy, adequacy, and understandability under regulatory requirements and industry standards. I have been retained on several occasions to provide expert opinions relating to issues such as these in the financial services industry.

7. Attached as Exhibit A is a complete curriculum vitae, including a list of my publications and a list of all other cases in which I have testified as an expert.

II. ENGAGEMENT

8. I understand that plaintiff Northstar Financial Advisors, Inc. (“Northstar”) has alleged claims against the Trustees of Schwab Investments (the “Trust”) and against Charles Schwab Investment Management, Inc. (the “Advisor”) for breach of fiduciary duty to investors and aiding and abetting the breach of fiduciary duty to investors by causing the Schwab Total Bond Market Fund (the “Fund”) to deviate from the Fund’s fundamental investment objective to “attempt to provide a high level of current income consistent with preservation of capital by seeking to track the investment results of [the Lehman Brothers Aggregate Bond Index (the ‘Bond Index’)].” The defendants also caused the Fund to deviate from its fundamental investment objective to not

1 concentrate more than 25% of its portfolio in any industry (such as non-agency collateralized
2 mortgage securities) that were not part of the Bond Index. *See* Plaintiff's Fourth Amended
3 Complaint dated June 25, 2014 [Dkt. No. 214], First through Fourth and Eighth through Eleventh
4 Causes of Action.

5 9. With respect to these claims, I have reviewed plaintiff's Fourth Amended Complaint,
6 the Ninth Circuit's decision sustaining plaintiff's claims for breach of fiduciary duty against the
7 Trustees, 779 F.3d 1036, 1056-62 (9th Cir. 2015) and the District Court's decision dated October 5,
8 2015 [Dkt No. 229], at pages 23-27, sustaining plaintiff's claims for breach of fiduciary duty against
9 the Advisor. I have also reviewed Schwab Investment's July 25, 1997 Proxy Statement [Dkt. 218-
10 1], establishing the Fund's fundamental investment objectives.

11 10. I have been asked by counsel for Northstar to analyze and express my professional
12 opinions on the performance of the Fund for the period September 1, 2007 through February 27,
13 2009, especially as it compares to the Fund's stated fundamental investment objective in its July 25,
14 1997 Proxy Statement.

15 11. I have also been asked to analyze and express my professional opinions on the
16 investment strategies implemented and investments made by the Advisor to the Fund, and the role of
17 the Trustees, especially as they compare to investments that would be required to realize the Fund's
18 stated fundamental investment objectives.

19 12. Last, I have been asked my professional opinion whether Northstar's claims for
20 breach of fiduciary duty are suitable for class action treatment and specifically whether common
21 issues of fact on Northstar's breach of fiduciary duty claims predominate over individual issues, and
22 whether plaintiff's class claims for breach of fiduciary duty can be proven by common evidence or
23 whether individual issues would predominate.

24 13. My compensation for this engagement is based on the number of hours worked and
25 my customary hourly rate of \$850. I am also reimbursed for out-of-pocket expenses.

26 14. A list of the documents I relied upon in forming my opinions are attached as Exhibit
27 B.

1 **III. SUMMARY OF OPINIONS**

2 15. Based on both my experience and my analysis of materials relevant to this case, I
 3 conclude that during the period September 1, 2007 through February 29, 2009, the Advisor and the
 4 Trustees breached their fiduciary duties by failing to manage the Fund's assets to achieve the Fund's
 5 fundamental investment objective of tracking the performance of the Bond Index. This caused the
 6 performance of the Fund to deviate from its investment objective. The Fund's performance simply
 7 stopped tracking the Bond Index and materially lagged behind the performance of the Bond Index
 8 and other fixed income funds with objectives similar to the Fund. Investors who placed money with
 9 the Bond Fund lost money compared to the Index, and other similar fixed income funds.

10 16. I also conclude that plaintiff's claims are appropriate for class action treatment
 11 because they can be proven by common evidence.

12 **IV. OPINIONS---THE FUND AND THE INDEX**

13 17. The July 25, 1997 Definitive Proxy Statement for the Fund [Dkt. No. 218-1] proposed
 14 a change in the Fund's fundamental investment objective. The Proxy Statement states (at 16) that
 15 the Fund's then-current "...fundamental investment objective is to attempt to provide a high level of
 16 current income consistent with preservation of capital by investing primarily in securities issued or
 17 guaranteed by the U.S. Government, its agencies or instrumentalities and repurchase agreements
 18 covering these securities." The Proxy Statement proposed (at 17-18) to change the Fund's
 19 fundamental investment objective to be to: "...attempt to provide a high level of current income
 20 consistent with preservation of capital by seeking to track the investment results of a particular bond
 21 index through the use of an indexing strategy.... If its proposed investment objective is approved,
 22 the Total Bond Fund would invest in a portfolio of fixed-income securities that seeks to track the
 23 Lehman Brothers Aggregate Bond Index (the 'Aggregate Bond Index'). The Aggregate Bond Index
 24 currently [and is still] a broad market-weighted index which encompasses the following classes of
 25 investment grade fixed-income securities: U.S. Treasury and agency securities, corporate bonds,
 26 international (dollar-denominated) bonds, mortgage-backed securities and asset-backed securities, all
 27 with maturities greater than one year."

1 18. The July 25, 1995 Proxy Statement also proposed that the Fund adopt the Securities
2 and Exchange Commission's definition of an "concentration" of securities, so that the Fund would not
3 invest more than 25% of its portfolio in any industry, except as necessary to track the Bond Index.
4 Dkt No. 218-1 at 32-33.

5 19. This proposed change was approved by a majority vote of shareholders on September
6 22, 1997. *See* Schwab Investments Prospectus Supplement dated September 25, 1997.

7 20. In my opinion, a fund's fundamental investment objective is the most important term
8 for investors in deciding in which funds to invest their money. This Proxy Statement, after it was
9 approved in September 1997, obligated the defendants to exercise their fiduciary duties to investors
10 to cause the Fund to invest its assets in a portfolio of fixed-income securities to seek to track the
11 investment results of the Bond Index through the use of an indexing strategy. Defendants had a
12 fiduciary duty to ensure that investors were invested in the U.S. dollar-denominated bond market as
13 a whole, and were earning returns similar to the performance of that Index.

14 21. The Index, now called the Barclays Capital Aggregate Bond Index, is described in its
15 public materials as covering the USD-denominated, investment-grade, fixed-rate, taxable bond
16 market of SEC-registered securities since 1986, with history measured back to January 1, 1976. *See*
17 *The Benchmark In Fixed Income: Barclays Capital Indices* at pages 37 and 38 (Exhibit C). In my
18 professional experience and opinion, the Index is among the best, if not the preeminent, index used
19 by investment professionals to measure the performance of the U.S. bond market.

20 22. The Fund's Prospectuses incorporated the Fund's fundamental investment objective
21 to track the Index. In the introduction to the entire family of funds, the Fund's November 15, 2006
22 Prospectus (amended July 13, 2007) says, "THE SCHWAB TOTAL BOND MARKET FUND TM
23 is designed to offer high current income by tracking the performance of the Lehman Brothers U.S.
24 Aggregate Bond Index. The fund is intended for investors seeking to fill the fixed income
25 component of their asset allocation plan." (Exhibit D; pp. 2, 14).

26 23. The Prospectus adds (in all caps), immediately after the name of the Fund: "THE
27 FUND SEEKS HIGH CURRENT INCOME BY TRACKING THE PERFORMANCE OF THE
28

1 LEHMAN BROTHERS U.S. AGGREGATE BOND INDEX” (the “Index”) (p. 14). It goes on to
 2 describe the Index and to state that “...Bonds are represented in the index in proportion to their
 3 market value...” and (again, in all caps) “TO PURSUE ITS GOAL, THE FUND PRIMARILY
 4 INVESTS IN A DIVERSIFIED PORTFOLIO OF DEBT INSTRUMENTS THAT IS DESIGNED
 5 TO TRACK THE PERFORMANCE OF THE LEHMAN BROTHERS U.S. AGGREGATE BOND
 6 INDEX. The fund uses the index as a guide in structuring the fund's portfolio and selecting its
 7 investments....” (p. 14).

8 24. In an October 2015 talk at Stanford University,
 9 <https://www.youtube.com/watch?v=W9Fqdqjacwk>, Charles Schwab, the founder and current
 10 Chairman of The Charles Schwab Corporation, discussed the value of investing in indexing in the
 11 bond market. In this context, he stated that he had learned quite some time ago that “...indexing
 12 created ninety percent of the eventual outcome...if you’re investing in bonds....” He made the same
 13 point about the value of indexing for other asset classes as well.

14 **V. OPINIONS---IMPLEMENTATION AND RESULTS**

15 25. I have compared the performance of the Fund in the Pre-Breach period from
 16 inception in late 1997 through August 31, 2007 against the performance of six investment funds that
 17 most closely matched the fundamental investment objective of the Schwab Total Bond Market Fund.
 18 (In the event any of the funds were not in existence as of August 1, 1997 – the approximate date on
 19 which the Fund began performance as a (purported) index fund -- the data is shown as of the first
 20 reported trading date for that fund on Bloomberg.)

21 a. The iShares Lehman Aggregate Bond Fund ETF [Electronic Traded Fund] (symbol:
 22 AGG) (Investment Objective: “The iShares Lehman Aggregate Bond Fund seeks
 23 investment results that correspond generally to the price and yield performance,
 24 before fees and expenses, of the total U.S. investment grade bond market as defined
 25 by the Lehman Brothers U.S. Aggregate Index”. Exhibit E (Excerpt of Prospectus
 26 dated July 1, 2007 at page 18)¹.

27 ¹ Certain of the SEC filings referenced herein are only appended in abstract because the full filings
 28 are hundreds of pages consisting of primarily irrelevant information concerning unrelated funds.

- 1 b. The Vanguard Total Bond Market ETF (symbol: BND) (Investment Objective: “The
2 Fund seeks to track the performance of a broad, market-weighted bond index.”)
3 Exhibit F (Excerpt of Prospectus dated April 2, 2007 at page 3).
- 4 c. Dreyfus Bond Market Index Fund (symbol: DBMIX) (Investment Objective: “The
5 fund seeks to match the total return of the Lehman Brothers U.S. Aggregate Index.”).
6 Exhibit G (Excerpt of Prospectus dated March 1, 2008 at page 1).
- 7 d. Fidelity Spartan U.S. Bond Index Fund (symbol: FSITX) (Investment Objective:
8 “The fund seeks to provide investment results that correspond to the aggregate price
9 and interest performance of the debt securities in the Barclays Capital® U.S.
10 Aggregate Bond Index.”). Exhibit H (“The fund seeks to provide investment results
11 that correspond to the aggregate price and interest performance of the debt securities
12 in the Barclays Capital® U.S. Aggregate Bond Index.”) (Summary Prospectus dated
13 May 10, 2011).
- 14 e. SPDR Lehman Aggregate Bond ETF (symbol: LAG; BNDS) (Investment Objective:
15 “[T]o provide investment results that, before fees and expenses, correspond generally
16 to the price and yield performance of an index that tracks the U.S. dollar denominated
17 investment grade bond market.”). Exhibit I (Excerpt of Prospectus dated October 31,
18 2007 at page 22).
- 19 f. Vanguard Total Bond Market Index Fund (symbol: VBMFX) (Investment Objective:
20 “The Fund seeks to track the performance of a broad, market-weighted bond index.”).
21 Exhibit J (Excerpt of Prospectus dated April 2, 2007 at page 2).
- 22 26. Exhibit K shows that the Schwab Total Bond Market Fund and the six other Bond
23 Funds with similar investment objectives to the Fund tracked the Index quite closely through August
24 2007. In my professional opinion, this is precisely what one would expect. Portfolios with similar
25 investment objectives should generate similar, but not necessarily identical, performance results to
26 the index they are tracking.

27 The complete filings are available on the SEC’s website and will be furnished to defendants or the
28 Court upon request.

1 27. In fact, in Exhibit L (TB 00004527-57 at 24; Schwab Total Bond Fund Review dated
2 June 30, 2007 – 2nd Quarter Review) Schwab shows that the Fund’s returns for the five-year period
3 ending June 30, 2007 have an R-squared of 98.93% when compared to the Index’s returns. This tells
4 us that the Fund tracked the Index’s returns very closely from 2002-2007, on the order of what we
5 would expect in light of defendants’ fiduciary duties.

6 28. However, beginning in approximately September 2007, the Fund failed to track the
7 performance of the Bond Index, while the other six investment funds continued to track the
8 performance of the Bond Index.

9 29. As can be seen from Exhibit M, starting in September 2007 the performance of the
10 Fund began to derail from the Bond Index and the other funds. By February of 2008 the Fund was
11 drastically underperforming the Bond Index and the other funds. It was no longer tracking the Bond
12 Index. Not close to 98%. Or even 90%. It continued to fail to track the Bond Index through
13 February of 2009.

14 30. As a direct result, the defendants’ breach of fiduciary duty to cause the Fund to track
15 the Index, anyone investing in the Fund would have lost money compared to defendants’ obligation
16 to manage the Fund pursuant to the Fund’s fundamental investment objective. In fact, investors in
17 the Fund, whether invested at the beginning or during the Breach Period (commencing September 1,
18 2007), lost money compared to the performance of the Index.

19 31. During this period, as shown in Exhibit M, the other funds with similar investment
20 objectives continued to track the Index while the Fund did not. In my professional opinion, this is a
21 material failure by the Fund to achieve its fundamental investment objective.

22 32. Upon inspection, not surprisingly in light of this performance failure, as of August 31,
23 2007 the Fund was no longer being managed by the defendants to track the performance of the Index.
24 Exhibit N shows the asset allocation differences between the August 31, 2007 iShares Core U.S.
25 Aggregate Bond ETF [Electronic Traded Fund]” (symbol: AGG), one of the six investment funds
26
27
28

described in Paragraph 23 above that closely matched the fundamental investment objectives of the Fund.²

33. Note two things: 1) there are material differences between the Fund's portfolio composition from that of AGG; and 2) like the other five investment funds, AGG continued to meet its fundamental investment objective after August 31, 2007 of tracking the Index, while the Fund did not.

34. Exhibit N shows that as of August 31, 2007 the Schwab portfolio was exposed to dramatically more mortgage backed securities (60.8% as compared to 47.3%), including non-agency collateralized mortgage obligations (36.7% as compared to 0%), and much less to U.S. Government bonds (8.8% as compared to 23%). *Compare* Schwab Total Market Bond Fund Annual Report dated August 31, 2007 (abstracted at Dkt No. 225-1) to AGG Semi-Annual Report dated August 31, 2007, pages 1-5 and 40-45 (abstracted at Exhibit O). The result was the dramatic underperformance of the Fund relative to the Index (and AGG) starting in September 2007, but especially from November 2, 2007 through February 27, 2009.

35. The Bond Index was constructed to withstand market turmoil and illiquidity in less creditworthy securities that were not part of the Index. Defendants, by failing to manage the Fund's fundamental investment objective, subjected the Fund to an intensified liquidity crisis and flight to safety after August 2007 and throughout 2008 that investors in bond index funds that adhered to their fundamental investment objectives to track the Index were not subjected to.

36. I have also concluded that this case is appropriate for class action treatment. I have been asked to assume that the elements of a claim for breach of fiduciary duty are: (1) existence of a duty that is fiduciary in nature based upon the relationship of the parties, (2) breach of that duty, (3) damages, and (4) a causal connection between breach of the duty and the damages. Each of those elements can be proven by common evidence. The existence of a duty and the breach of that duty is uniform for all class members who held shares of the Fund at any time from September 1, 2007

² The actual composition of the index is not publicly available. However, the composition of the other investment funds is a reasonable proxy for the index.

1 through February 27, 2009. Damages can be proven by analyzing the difference in daily
2 performance between the Bond Index (which is publicly reported under the symbol: LBSTRUU)
3 and the Fund's NAV (which is publicly reported under the symbol SWLBX). The causal connection
4 between defendants' breaches of fiduciary duty and damages can also be proven by common,
5 evidence (*i.e.*, the under-performance of the securities that are not part of the Index compared to the
6 securities that are part of the Index). In fact, the Schwab Total Bond Market is an open-ended
7 mutual fund. Each share of the Fund is bought or sold directly in privity with the Trust, and thus
8 defendants have knowledge of the names and trading information for all shareholders. There is no
9 need for a damages expert to estimate class-wide damages. Damages can be calculated with
10 mathematical precision for each shareholder.

11
12 Dated: January 20, 2016


13 Steven W. Kohlhausen